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Parent, a U.S. corporation and the common parent of an affiliated group of corporations that files a federal consolidated income tax return, is an accrual method taxpayer on a 52/53 week taxable year. Parent conducts its activities directly and through domestic and foreign subsidiaries, each of which along with Parent has the dollar as its functional currency, as defined in section 985(b)(1) of the Internal Revenue Code of 1986, as amended (the “Code”).

Parent manufactures a variety of highly sophisticated technological devices, including Products and related components. This manufacturing business requires Parent to expend substantial capital to construct, maintain and upgrade state-of-the-art factories. Parent invests a large percentage of this cost in acquiring customized equipment that it uses to manufacture and test Products. Because Products technology is continuously advancing, Parent's manufacturing processes frequently become out-dated, and Parent must develop and implement new manufacturing processes for certain Products in cycles that are typically as short as two years. To acquire the necessary manufacturing and testing equipment in time to keep up with technological advances, Parent must forecast its manufacturing capacity needs and begin negotiating with its equipment suppliers up to five years in advance of the date that such tools will actually be delivered and placed in service. Thus, Parent must begin this long-range process of acquiring new equipment even before it has designed the new generation of Products.

Parent begins this long-range planning process by forecasting its production needs for the next several years. Parent then projects the quantity and timing of new capital equipment purchases it will need to make to up-grade its factories to meet its production forecasts for newer Products. Based on these projections, Parent enters into multi-year master procurement agreements with various equipment suppliers. Each such agreement sets forth the standard terms and conditions for all equipment purchase orders that Parent may choose to place with the supplier that is party to the agreement during the life of the agreement, which is typically three to five years. These terms include a specified purchase price for the defined types of equipment covered by the agreement. Although the agreement commits the equipment supplier to a maximum fixed sales price during the term of the agreement, it does not commit Parent to make any specific number of purchases.

After entering into a procurement agreement, Parent will typically wait up to several years before placing actual purchase orders for specific pieces of equipment. Parent times the placement of such orders by forecasting when its factories will need the equipment and estimating how long it will take the supplier to manufacture the equipment. Suppliers generally take less than a year from the date a purchase order is placed to deliver a piece of equipment. Thus, Parent locks in a price for the equipment long before placing a specific order.

Parent frequently enters into procurement agreements and purchases equipment from suppliers that are resident in countries outside the U.S. Initially, Parent paid U.S. dollars to acquire equipment from these foreign suppliers. When foreign suppliers priced their equipment in U.S. dollars, the price typically reflected either compensation to the supplier for assuming the currency risk inherent in committing to a multi-year contract in non-functional currency or compensation for the cost of hedging that foreign currency exposure. Parent concluded that it would save money if it negotiated the price terms of its procurement agreements in the currency of the foreign supplier and then entered into its own currency hedges. Parent believed that it could forecast the quantity

and timing of its equipment purchase orders more reliably than its suppliers could. Consequently, Parent believed it would cost less to hedge its own foreign currency exposure than to compensate the supplier for assuming that risk.

In accordance with its current internal hedging policy, Parent hedges A% to B% of the foreign currency exposure it expects will arise from foreign-currency priced procurement agreements. Parent may use a variety of hedging instruments and strategies, but predominantly foreign currency forward contracts.

Parent structures and implements each of its foreign currency hedges and continually monitors them so as to qualify them for hedge accounting under Financial Accounting Standards Board Statement No. 133 ("FAS 133"). To ensure that its designated hedging instruments as well as its hedged transactions qualify for hedge accounting under FAS 133, Parent routinely complies with the following procedures and criteria, as required by FAS 133.

First, at inception of the hedge, Parent formally documents the hedging relationship and Parent's risk management objective and strategy for undertaking the hedge. Such documentation includes identification of the hedging instrument, the hedged transaction, the nature of the risk being hedged, and how the hedging instrument's effectiveness in hedging the exposure to the hedged transaction's variability in cash flows attributable to the hedged risk will be assessed. Parent also provides a reasonable basis for financial reporting purposes for how it plans to assess the hedging instrument's effectiveness. In providing this documentation, Parent describes the hedged forecasted transaction with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction.

Second, at both inception of the hedge and on an ongoing basis, Parent makes an assessment as required under FAS 133 to ensure that the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge. Parent re-assesses such effectiveness whenever it reports financial statements or earnings and at least every three months. Parent uses the cumulative dollar-offset method to assess the effectiveness of hedges, both prospectively and retrospectively. Thus, Parent gauges effectiveness based on a dollar-offset ratio defined by (1) the cumulative changes in cash flows on the hedging derivative instrument divided by (2) the forecasted cumulative changes in cash flows on the hedged item. Parent uses a range for the dollar-offset ratio that is consistent with industry practice and published accounting guidance.

Third, Parent identifies the hedged transaction as a single transaction or a group of individual transactions; provided that, if the hedged transaction is a group of individual transactions, those individual transactions share the same risk exposure for which they are designated as being hedged. Thus, Parent does not aggregate and treat as a single hedged transaction expected purchases with different forecasted probabilities.

Fourth, Parent makes an assessment as required under FAS 133 to ensure that the hedging relationship is probable. With respect to this probability assessment, Parent's Treasury Accounting function evaluates business forecasts and analysis provided by other functions within Parent to calculate the probability of purchasing a certain amount of equipment. Parent's policy is to hedge only those transactions that have at least the minimal probability of occurring that is required by FAS 133. Parent generally understands a hedged transaction to satisfy this minimum probability requirement when it has at least a 75% to 80% likelihood of occurring and when it is expected to occur no later than a certain number of days (which varies by type of exposure). After executing a hedge, Parent re-assesses the probability of its hedged transactions at least quarterly.

Because FAS 133 requires that an entity discontinue hedge accounting prospectively if the qualifying criteria are no longer met, Parent has three internal controls to detect instances in which projected purchases may be over-hedged. First, Parent compiles updated equipment purchase forecasts on a quarterly basis and compares them to updated forecasts of hedge amounts. Second, on a quarterly basis Parent compares the amount of spending projected in the monthly hedge effectiveness report to the amount of Parent's latest forecast for equipment purchases. Third, Parent continuously monitors changes in business circumstances that affect future equipment purchase orders. If Parent detected an instance in which it were over-hedged with respect to a hedged transaction, it would discontinue hedge accounting for the hedge instrument pursuant to FAS 133 and would also take steps to eliminate the over-hedging, which may include unwinding the hedge, reducing the size of the hedge or selling the hedge instrument.

In complying with these procedures and criteria, Parent uses a variety of Sarbanes Oxley controls to ensure that its internal functions are reporting quality hedging data for purposes of evaluating equipment purchase probability, hedge instrument effectiveness and potential hedging inconsistencies that might result in over-hedging. Such controls are monitored and tested at least annually.

Parent has requested a ruling under the authority provided in Treas. Reg. § 1.988-5(e) that it be permitted to apply the principles of the integrated hedged executory contract rules of Treas. Reg. § 1.988-5(b) to hedges of anticipated capital equipment purchases under master procurement agreements.

Law

Section 988(d)(1) of the Code provides that, to the extent provided in regulations, if any section 988 transaction is part of a 988 hedging transaction, all transactions which are part of such 988 hedging transaction shall be integrated and treated as a single transaction or otherwise treated consistently for purpose of this subtitle.

Section 988(d)(2) of the Code provides that the term "988 hedging transaction" means any transaction—(A) entered into by the taxpayer primarily—(i) to manage risk of

currency fluctuations with respect to property which is held or to be held by the taxpayer, or (ii) to manage risk of currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, by the taxpayer, and (B) identified by the Secretary or the taxpayer as being a 988 hedging transaction.

Treas. Reg. § 1.988-5(b)(1) provides that if the taxpayer enters into a hedged executory contract as defined in paragraph (b)(2) of this section, the executory contract and the hedge shall be integrated as provided in paragraph (b)(4) of this section.

Treas. Reg. § 1.988-5(b)(2)(i) provides that a hedged executory contract is an executory contract as defined in paragraph (b)(2)(ii) of this section that is the subject of a hedge as defined in paragraph (b)(2)(iii) of this section, provided that the following requirements are satisfied—(A) The executory contract and the hedge are identified as a hedged executory contract as provided in paragraph (b)(3) of this section. (B) The hedge is entered into (i.e., settled or closed, or in the case of nonfunctional currency deposited in an account with a bank or other financial institution, such currency is acquired and deposited) on or after the date the executory contract is entered into and before the accrual date as defined in paragraph (b)(2)(iv) of this section. (C) The executory contract is hedged in whole or in part throughout the period beginning with the date the hedge is identified in accordance with paragraph (b)(3) of this section and ending on or after the accrual date. (D) None of the parties to the hedge are related. The term related means the relationships defined in section 267(b) and section 707(c)(1). (E) In the case of a qualified business unit with a residence, as defined in section 988(a)(3)(B), outside of the United States, both the executory contract and the hedge are properly reflected on the books of the same qualified business unit. (F) Subject to the limitations of paragraph (b)(2)(i)(E) of this section, both the executory contract and the hedge are entered into by the same individual, partnership, trust, estate, or corporation. With respect to a corporation, the same corporation must enter into both the executory contract and the hedge whether or not such corporation is a member of an affiliated group of corporations that files a consolidated return. (G) With respect to a foreign person engaged in a U.S. trade or business that enters into an executory contract or hedge through such trade or business, all items of income and expense associated with the executory contract and the hedge would have been effectively connected with such U.S. trade or business throughout the term of the hedged executory contract had this paragraph (b) not applied.

Treas. Reg. § 1.988-5(b)(2)(ii) provides that, except as provided in paragraph (b)(2)(ii)(B) of this section, an executory contract is an agreement entered into before the accrual date to pay nonfunctional currency (or an amount determined with reference thereto) in the future with respect to the purchase of property used in the ordinary course of the taxpayer's business, or the acquisition of a service (or services), in the future, or to receive nonfunctional currency (or an amount determined with reference thereto) in the future with respect to the sale of property used or held for sale in the ordinary course of the taxpayer's business, or the performance of a service (or services), in the future.

Treas. Reg. § 1.988-5(b)(2)(iii)(A) provides that the term hedge means a deposit of nonfunctional currency in a hedging account (as defined paragraph (b)(3)(iii)(D) of this section), a forward or futures contract described in § 1.988-1(a)(1)(ii) and (2)(iii), or combination thereof, which reduces the risk of exchange rate fluctuations by reference to the taxpayer's functional currency with respect to nonfunctional currency payments made or received under an executory contract.

Treas. Reg. § 1.988-5(b)(2)(iii)(B) provides that a series of hedges as defined in paragraph (b)(3)(iii)(A) of this section shall be considered a hedge if the executory contract is hedged in whole or in part throughout the period beginning with the date the hedge is identified in accordance with paragraph (b)(3)(i) of this section and ending on or after the accrual date. A taxpayer that enters into a series of hedges will be deemed to have satisfied the preceding sentence if the hedge that succeeds a hedge that has been terminated is entered into no later than the business day following such termination.

Treas. Reg. § 1.988-5(b)(3) provides that a taxpayer must establish a record and before the close of the date the hedge is entered into, the taxpayer must enter into the record a clear description of the executory contract and the hedge and indicate that the transaction is being identified in accordance with paragraph (b)(3) of this section.

Treas. Reg. § 1.988-5(e) provides that in his sole discretion, the Commissioner may issue an advance ruling addressing the income tax consequences of a taxpayer's system of hedging either its net nonfunctional currency exposure or anticipated nonfunctional currency exposure. The ruling may address the character, source, and timing of both the section 988 transaction(s) making up the hedge and the underlying transactions being hedged. The procedures for obtaining a ruling shall be governed by such pertinent revenue procedures and revenue rulings as the Commissioner may provide. The Commissioner will not issue a ruling regarding hedges of a taxpayer's investment in a foreign subsidiary.

Analysis

When Parent enters into a master procurement agreement, it has no binding obligation to place any orders in the future with the supplier that is party to the agreement. Thus, such master procurement agreements are not executory contracts and do not qualify for integrated hedging treatment under Treas. Reg. § 1.988-5(b). Absent an advance ruling to the contrary under Treas. Reg. § 1.988-5(e), Parent is required to treat the financial instruments it enters into to hedge its underlying foreign currency exposure on its procurement agreements as separate section 988 transactions that are not integrated with the underlying equipment purchase transactions.

Parent conducts its activities directly and through domestic and foreign subsidiaries, all of which have the dollar as their functional currency. When Parent enters into master

procurement agreements with equipment suppliers and agrees to a fixed price in a foreign currency for future equipment orders, Parent is subjecting itself to the risk of currency fluctuations in that foreign currency with respect to transactions that have at least the minimal probability of occurring (as governed by FAS 133) for the period between the time it enters into the agreement and the time it places an order under the agreement. (Such transactions are hereafter referred to as “probable transactions.”) Accordingly, when Parent enters into such agreement, it also acquires forward contracts and/or similar financial instruments to hedge A% to B% of the currency risk arising with respect to such probable transactions.

We have determined that Parent should be allowed to apply the principles of Treas. Reg. § 1.988-5(b) to integrate its hedges of underlying foreign currency exposure with respect to its probable transactions with the probable equipment purchase transactions under its procurement agreements for the following reasons:

- (1) Parent's highly sophisticated manufacturing business requires Parent to expend substantial capital to maintain and upgrade state-of-the-art factories that frequently become obsolete and must be replaced. In maintaining and upgrading such facilities and equipment, Parent must anticipate its capacity needs several years in advance of ordering new equipment.
- (2) Parent has a complex and highly disciplined long-range planning process in place for projecting its needs for manufacturing capacity and for acquiring the capital equipment required to meet those needs.
- (3) Parent has internal controls and procedures in place to ensure that it only executes hedges of its underlying foreign currency exposure on its procurement agreements that meet the requirements for Cash Flow Hedge Accounting Treatment under FAS 133. Specifically, (a) Parent formally documents the hedging relationship and Parent's risk management objective and strategy for undertaking the hedge, (b) at both inception of the hedge and on an ongoing basis, Parent makes an assessment as required under FAS 133 to ensure that the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge, (c) Parent identifies the hedged transaction as a single transaction or a group of individual transactions; provided that, if the hedged transaction is a group of individual transactions, those individual transactions share the same risk exposure for which they are designated as being hedged, and (d) Parent's policy is to hedge only those transactions that have at least the minimal probability of occurring that is required by FAS 133.
- (4) Parent routinely re-evaluates each hedge's compliance with these requirements and discontinues hedge accounting treatment whenever any of these criteria are no longer fully met.

(5) Parent has represented that if, due to a revised forecast, Parent no longer anticipates making a scheduled equipment purchase under a master procurement agreement, Parent will treat the hedge as sold for its fair market value for federal income tax purposes on the date that it makes such determination.

Rulings

Based on the information submitted and the representations made, we rule as follows:

(a) Conditions for applying the principles of Treas. Reg. § 1.988-5(b). Under the authority provided in Treas. Reg. § 1.988-5(e), we grant Parent permission to apply the principles of Treas. Reg. § 1.988-5(b) (as described in the paragraph (b) below) to hedges of anticipated capital equipment purchases under master procurement agreements described in the facts above provided that:

(1) The anticipated purchase is covered by a procurement agreement that provides for a specified purchase price denominated in foreign currency;

(2) The anticipated purchase has been approved by Parent pursuant to Parent's internal long-range planning process;

(3) The hedge meets the requirements for Cash Flow Hedge Accounting Treatment under FAS 133; and

(4) If, due to a revised forecast, Parent no longer anticipates making the hedged anticipated purchase, or if the hedge fails to continue to meet the criteria for hedge accounting treatment under FAS 133, the hedge is treated as having been sold for its fair market value for federal income tax purposes on the date that such determination is made.

(b) Principles of Treas. Reg. § 1.988-5(b). Taxpayer shall apply the principles of Treas. Reg. § 1.988-5(b) to hedges of anticipated capital equipment purchases under master procurement agreements meeting the requirements of paragraph (a) above as follows:

(1) An anticipated capital equipment purchase made under a master procurement agreement meeting the requirements of the paragraph (a) shall be treated as if it were an executory contract for purposes of applying Treas. Reg. § 1.988-5(b) (hereafter referred to as "deemed executory contract").

(2) When Parent places an actual purchase order with respect to an anticipated capital equipment purchase described in paragraph (b)(1), the purchase order will be treated as a continuation of the deemed executory contract described in paragraph (b)(1).

(3) Where taxpayer takes delivery on a purchase order described in paragraph (b)(2) and that order is subject to a hedge meeting the requirements for Cash Flow Hedge Accounting Treatment under FAS 133, any gain or loss on the hedge shall not be recognized but shall be an adjustment to the purchase price of the capital equipment.

(4) If Parent terminates a purchase order described in paragraph (b)(2) prior to the delivery date, the associated FAS 133 hedge shall be treated as sold for its fair market value on that termination date and any gain or loss shall be recognized on such date as section 988 gain or loss.

(5) If Parent terminates or disposes of a FAS 133 hedge prior to the delivery date under a purchase order, any gain or loss realized on such disposition (determined by reference to the spot rate on that date) will not be recognized but will instead be treated as an adjustment to the purchase price of the equipment purchased under the purchase order.

(6) If at any time a hedge associated with a procurement agreement or purchase order described in paragraphs (b)(1) and (2) fails to meet the requirements for integrated hedging treatment under FAS 133, the hedge will be treated as having been sold for its fair market value and any gain or loss on the hedge will be realized and recognized on such date as section 988 gain or loss.

Caveats

We express no opinion on any provisions of the Code or regulations not specifically covered by the above ruling.

Procedural Statements

This ruling is directed only to Parent. Code section 6110(k)(3) provides that it may not be used or cited as precedent. Parent should attach a copy of this ruling letter to its Federal income tax return for the taxable years to which this letter applies.

Sincerely yours,

Jeffrey L. Dorfman
Branch Chief, Branch 5
Office of Associate Chief Counsel
(International)